

**COORDINATED ISSUE
FOREST PRODUCTS INDUSTRY
LOSSES OF TIMBER FOLLOWING AN EPIDEMIC ATTACK
OF SOUTHERN PINE BEETLES**

ISSUES

- (1) Is a deduction allowable as a casualty loss under I.R.C. section 165(a) for loss of timber following an epidemic attack of southern pine beetles?
- (2) If not, is a deduction allowable under section 165(a) as a non-casualty loss incurred in a trade or business, or must the cost of the lost timber be recovered through depletion under Treas. Reg. 1.611-3(e)?
- (3) If a deduction is allowed, what is the proper method of determining the amount of the allowable loss, and what is the proper treatment of the loss under section 1231?
- (4) Is section 1033 treatment allowable for section 631(a) gains derived from cutting healthy trees to isolate beetle infestations?

BACKGROUND, LAW, AND ANALYSIS

Under normal conditions, the southern pine beetle exists in the forest in endemic populations, i.e., populations which increase at a lesser rate than those environmental factors that normally keep populations in balance. Normally, healthy trees repulse the attack of endemic populations; healthy trees are unable to withstand attacks of epidemic populations and succumb within a short period. If the timber in affected trees is not harvested, the trees become subject to borers and other decay organisms which render the timber unfit for its intended use.

Timber companies conduct salvage operations to save the timber in the dead trees. Any worthless timber is bulldozed and burnt as the site is prepared for planting. Also, healthy, undamaged trees may be harvested to stop the spread of the beetle infestation.

With respect to unsalvageable timber, a taxpayer, as a general rule, may deduct under section 165(a) any loss sustained during the taxable year and not compensated for by insurance or otherwise. Amplifying the statute, Treas. Reg. 1.165-1(b) states that an allowable loss "must be evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year." Deduction of

losses of individuals not incurred in either a trade or business or in a transaction entered into for profit are limited to those arising from fire, storm, shipwreck, or other casualty. Section 165(c) (3). **See also** Treas. Reg. 1.165-7(a). Although losses incurred by businesses are generally not limited to casualty losses, the distinction is nevertheless important for purposes of section 1231. See, e.g., section 1231(a) (4) (C).

Neither the statute nor the implementing regulations define the term "other casualty"; nor does the legislative history of section 165 provide any guidance as to its meaning. **Maher v. Commissioner**, 76 T.C. 593, 596 (1981), **aff'd**, 680 F.2d 91 (11th Cir. 1982). Courts have limited its meaning to "an accident, a mishap, some sudden invasion by a hostile agency; it excludes the progressive deterioration of property through a steadily operating cause." **Fay v. Helvering**, 120 F.2d 253 (2d Cir. 1941). The term has been construed to mean an identifiable and damaging event that is sudden, unusual, or unexpected. **Matheson v. Commissioner**, 54 F.2d 537, 539 (2d Cir. 1931).

In the Service's view, an epidemic attack of beetles constitutes a casualty with respect to ornamental trees and is not a casualty with respect to merchantable timber trees. In Rev. Rul. 87-59, 1987-2 C.B. 59, **distinguishing** Rev. Rul. 79-174, 1979-1 C.B. 99, and Rev. Rul. 66-9, 1966-1 C.B. 39, the Service held that a loss to timber producing property after an epidemic attack of beetles was not a casualty loss. The Service reasoned that although the attack killed the trees, there was no immediate effect on the timber. The death of the trees rendered them vulnerable to other wood-destroying organisms and the loss of the timber was progressive rather than sudden as required under section 165. In Rev. Rul. 79-174, reasoning that the trees become worthless as ornamentals at death within a few days of the attack, the Service concluded that the taxpayer was entitled to a casualty loss. **See also Nelson v. Commissioner**, T.C. Memo. 1968- 35, and **Black v. Commissioner**, T.C. Memo. 1977-337.

A conflict exists among the courts on whether taxpayer is entitled to a casualty loss for timber subject to an epidemic attack. This conflict surrounds the "suddenness" requirement of the statute. Some courts have applied the suddenness requirement to the precipitating event in concluding that taxpayers suffered a casualty loss. **E.g., Oregon Mesabi Corp. v. Commissioner**, 39 B.T.A. 1033 (1939) (interpreted as permitting a casualty loss for timber in trees killed by fire) and **Shopmaker v. United States**, 119 F. Supp. 705 (E.D. Mo. 1953) (casualty loss allowable because initial infestation by termites was sudden). Other courts have measured the suddenness of the loss itself, **i.e.**, the lapse of time between the precipitating event and the loss proximately caused by that event. **E.g., Maher, supra** (citing similar cases).

Relying on **Nelson**, **Black**, and **Smithgall v. United States**, 47AFTR 2d 81-695, 81-1 USTC 9121 (N.D. Ga. 1980), involving the loss of ornamental trees, the United States

Court of Federal Claims determined that the infestation of taxpayer's timber forests in epidemic proportions constituted a casualty event under section 165. **Weyerhaeuser v. United States**, 32 Fed. Cl. 80 (1994). Because the taxpayer failed to produce records substantiating the alleged losses, however, the court did not allow any deduction for the claimed losses. Accordingly, their characterization by the court as casualty losses was not appealable. The Service will continue to follow Rev. Rul. 87-59.

With respect to healthy trees that are cut to isolate the beetle infestation, a taxpayer may elect to treat gains from the cutting of such timber held for more than one year for sale or use in the taxpayer's trade or business as gain from the sale of a capital asset. Section 631(a).

Section 1033(a) provides that if property "(as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof)" is involuntarily converted into money or into property not similar or related in service or use to the converted property, no gain will be recognized if a taxpayer so elects and purchases certain specified replacement property within a period provided by section 1033(a)(2)(B).

The basic purpose of section 1033 is to allow the taxpayer to replace property without realization of gain where compelled to give up such property because of circumstances beyond the control of the taxpayer. **S. H. Kress and Co. v. Commissioner**, 40 T.C. 142, 153 (1963). This section evinces a Congressional intent to grant a measure of tax relief to those who were compelled by the specified circumstances to convert their property into cash. **S & B Realty Co. v. Commissioner**, 54 T.C. 863, 871 (1970), **acq.** 1970-2 C.B. xxi. Thus, where partially damaged property is repairable and the taxpayer chooses to dispose of it at a gain rather than make the necessary repairs, the proceeds of sale and insurance proceeds fail to qualify for nonrecognition treatment. **C. G. Willis, Inc. v. Commissioner**, 41 T.C. 468 (1964).

The Service has published its position that, under section 1033, a taxpayer will not recognize gain on proceeds received from the sale of timber downed by high winds, earthquake, or volcanic eruption when the sale of the downed timber is dictated (or forced) by the damage, and the proceeds are used to purchase other standing timber. Rev. Rul. 80-175, 1980-2 C.B. 230, **revoking** Rev. Rul. 72-372, 1972-2 C.B. 471.

The rationale of Rev. Rul. 80-175 does not apply to gains from the sale or deemed sale of timber harvested from healthy, undamaged trees cut to prevent the spread of a beetle infestation. The terms "threat or imminence thereof" refer only to cases of destruction by "requisition or condemnation." See **Treas. Reg. Sec. 1.1033(a)-1**. The statute does not cover situations where no destruction has occurred at the time taxpayer decides to dispose of the property.

SERVICE POSITION

Rev. Rul. 87-59 continues to be Service position on the casualty and non-casualty loss issues, and the treatment of the loss for purposes of section 1231. Service position on the entitlement to nonrecognition is contained in Rev. Rul. 80-175.

1. Because the events causing the losses lack the requisite suddenness, no deduction on the basis of casualty is allowable. The loss in question was the death of beetle-infested trees -- those that contained timber that ultimately could not be salvaged -- and the worthlessness of the timber in those trees. This loss was the direct result, not just of the beetle attacks -- which killed the trees but left the merchantable timber largely intact -- but also of ensuing progressive physical damage caused by wood-destroying insects and fungi.
2. A finding of casualty is not a prerequisite to the allowance of a loss. The taxpayer is entitled to deduct under section 165(a) any timber lost in excess of normal, expected, mortality losses, to the extent it can establish through objective facts that, as of a determinable date, that timber had deteriorated to the point of being unsalvageable.
3. The amount the taxpayer is entitled to deduct under section 165(a) is its adjusted basis in each worthless unit of unsalvageable timber. The losses, since they resulted from the involuntary conversion of real property used in the trade or business, must be included in the computation of net gain or loss under section 1231(a). Since they do not arise from a casualty, they do not enter into the "preliminary hotchpot" computation under Treas. Reg. Sec. 1.1231-1(e) (3). **See** Rev. Rul. 87-59. For most cases, this will result in a reduction of the net capital gain rather than an ordinary loss.
4. Section 631(a) gains resulting from the cutting of healthy trees to isolate the beetle infestation are not eligible for section 1033 treatment since these trees were cut as a result of the threat or imminence of the beetle attack, not as a result of the attack itself.